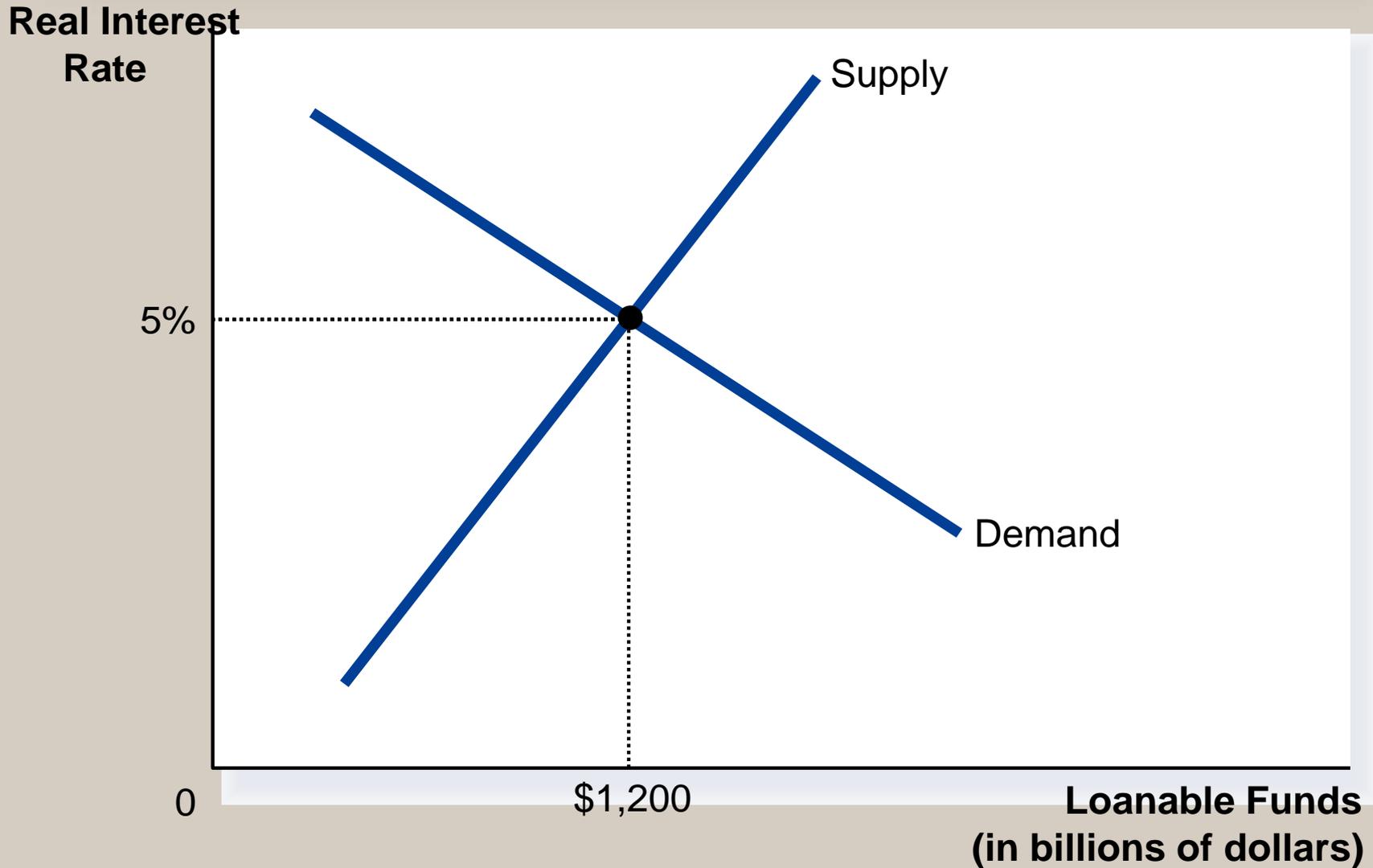


Loanable Funds Market

THE MARKET FOR LOANABLE FUNDS

- The *market for loanable funds* is the market in which those who want to save supply funds and those who want to borrow to invest demand funds.
- Loanable funds refers to all income that people/banks have **chosen to save and lend out**, rather than use for their own consumption.

Figure 1 The Market for Loanable Funds



Supply and Demand for Loanable Funds

- The supply of loanable funds comes from people who have extra income they want to save and lend out.
- The demand for loanable funds comes from households and firms that wish to borrow to make investments.
- The interest rate in the market for loanable funds is the **real interest rate. (This is a longer term market than the MM)**

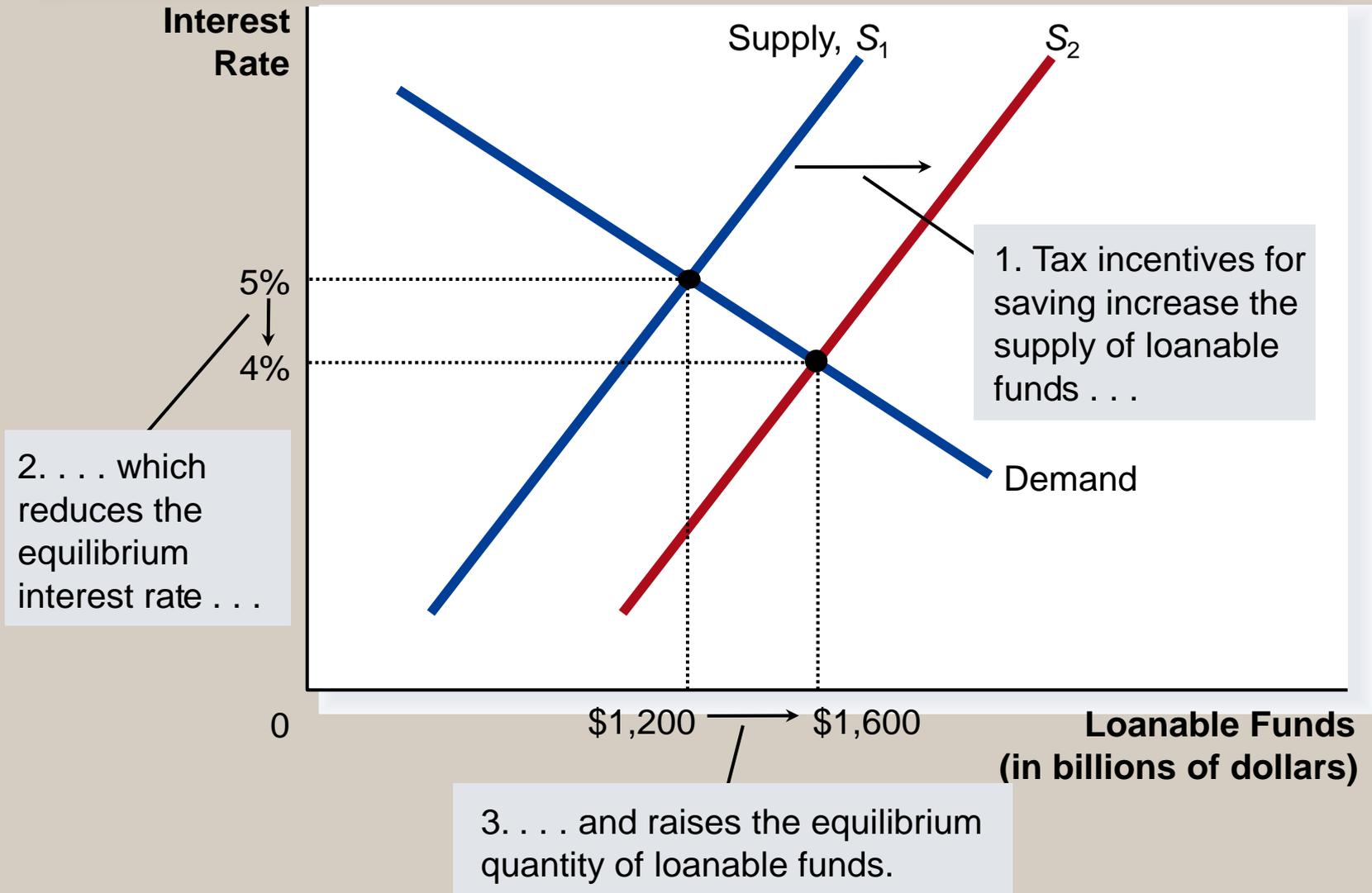
Government Policies That Affect Saving and Investment

- Taxes and saving (SUPPLY)
- Taxes and investment (DEMAND)
- Government budget deficits (EITHER *depending on approach*)

Supply of Loanable Funds: Saving Incentives

- Taxes on interest income reduce the incentive to save.
- A **tax decrease** increases the incentive for households to save at any given interest rate.
 - The supply of loanable funds curve shifts to the right.
 - The equilibrium interest rate decreases.
 - The quantity demanded for loanable funds increases.
- If a change in tax law encourages greater saving, the result will be *lower* interest rates and *greater quantity* invested and vice versa

Figure 2 An Increase in the Supply of Loanable Funds

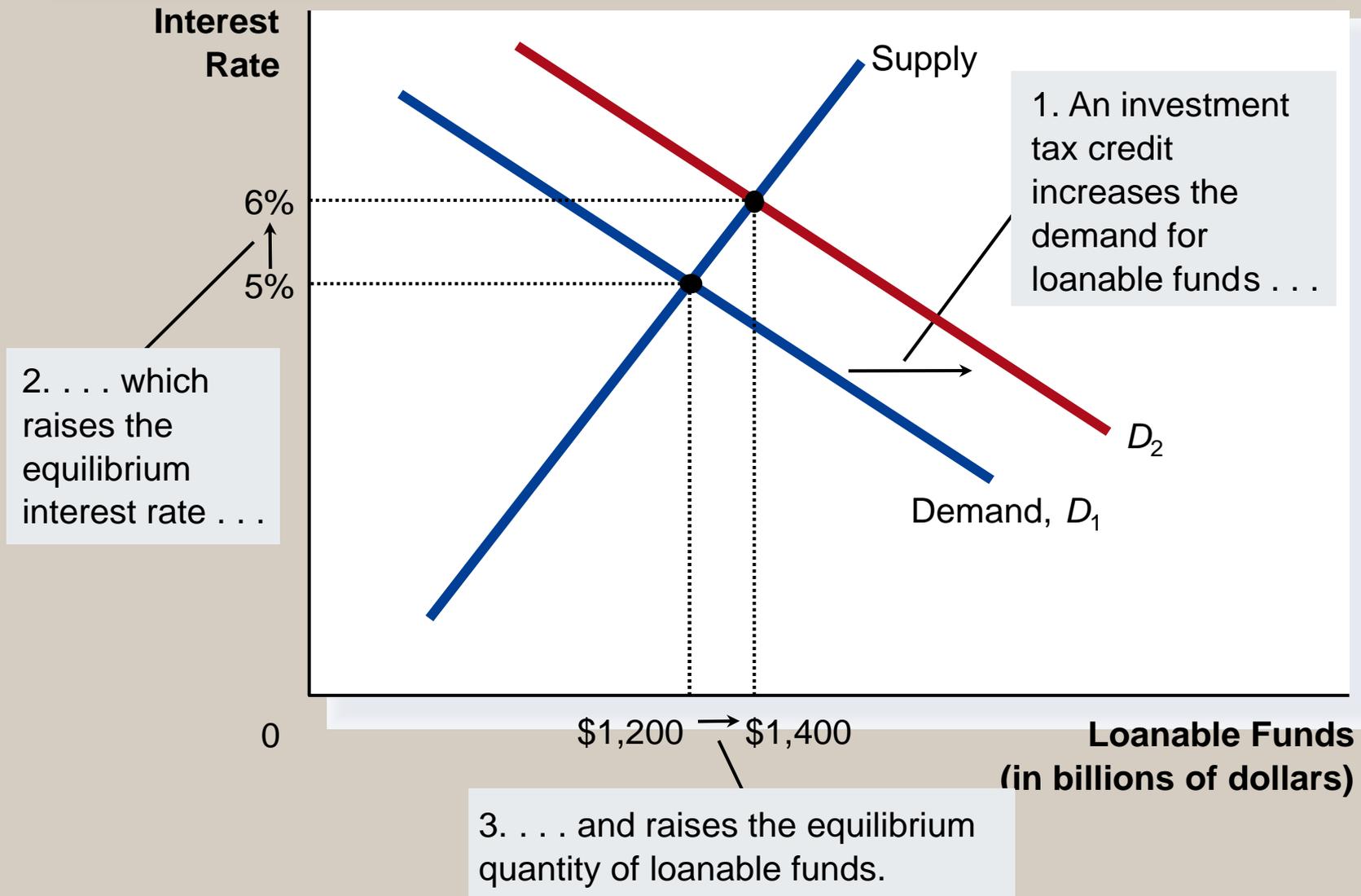


Demand for Loanable Funds:

Investment Incentives

- An investment tax credit increases the incentive to borrow.
 - Increases the demand for loanable funds.
 - Shifts the demand curve to the right.
 - Results in a higher interest rate and a greater quantity saved.
- If a change in tax laws encourages greater investment, the result will be *higher* interest rates and *greater quantity* saved and vice versa

Figure 3 An Increase in the Demand for Loanable Funds



Differences in LFM and MM

Money Market

- All money in economy (usually M2)
- Affects nominal interest rates (fisher equation)
- Supply controlled by FED
- Demand mostly influenced by need for cash
- Fiscal policies have little effect

Loanable Funds

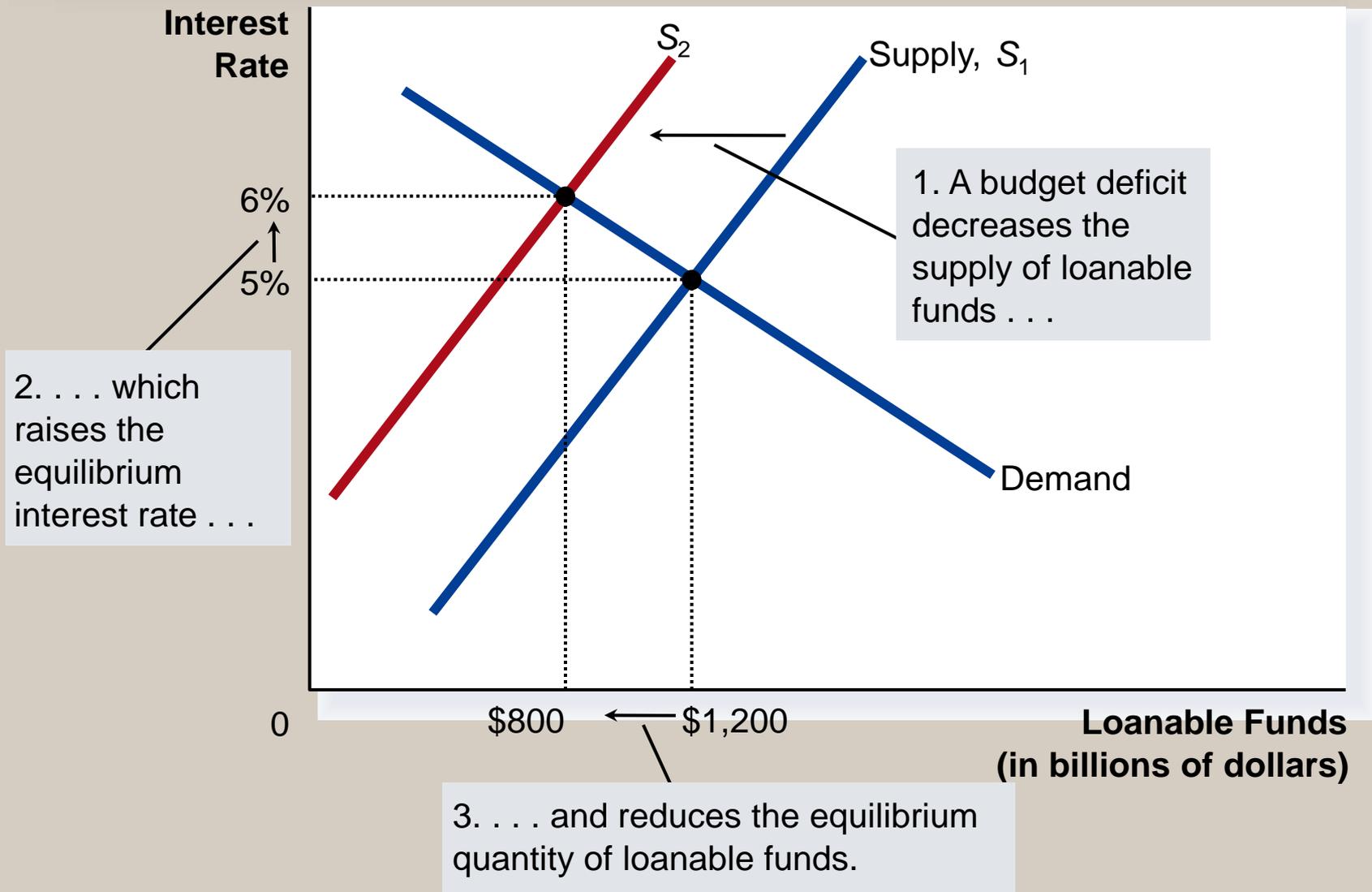
- ONLY money available for lending
- Affects real interest rates
- Supply controlled by private savings decisions
- Demand mostly influenced by incentive to invest (I)
- Fiscal policies have MAJOR effect (crowding out)

CROWDING OUT

Definition

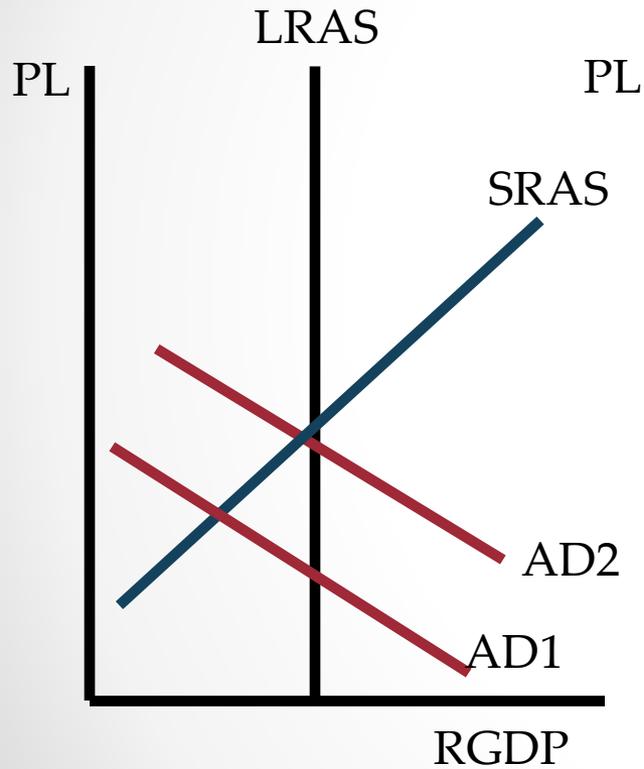
- ***Crowding out* occurs via the following sequence of events:**
 - **1. The government runs a deficit**
 - **2. To finance the deficit, government borrows money from private savings**
 - **3. The reduction in supply* of available savings drives interest rates higher**
 - **4. The higher interest rates decrease (CROWDS OUT) private investment, decreasing AD**
 - *** - Some argue it's not the reduction in supply of available funds that drives up interest rates, but an increase in the number of DEMANDERS of loans. EITHER argument has the same effect!!!!**

Figure 4: The Effect of a Government Budget Deficit

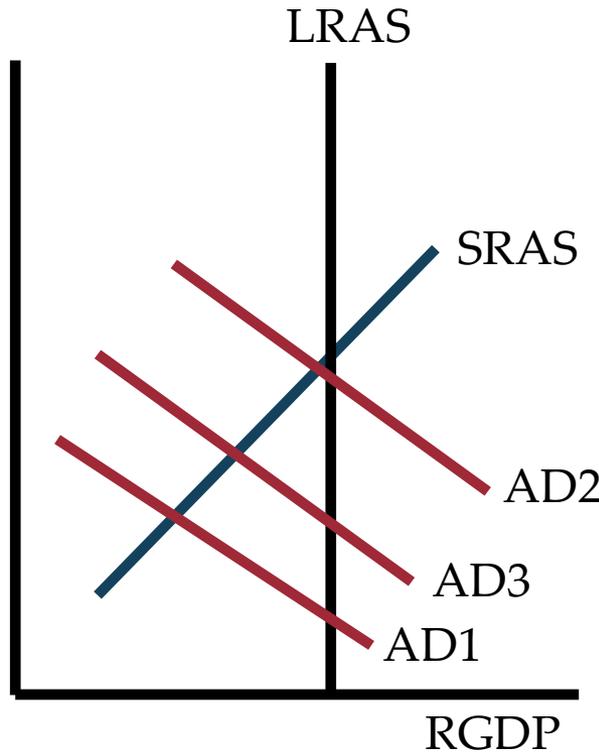


3 Possible options for crowding out

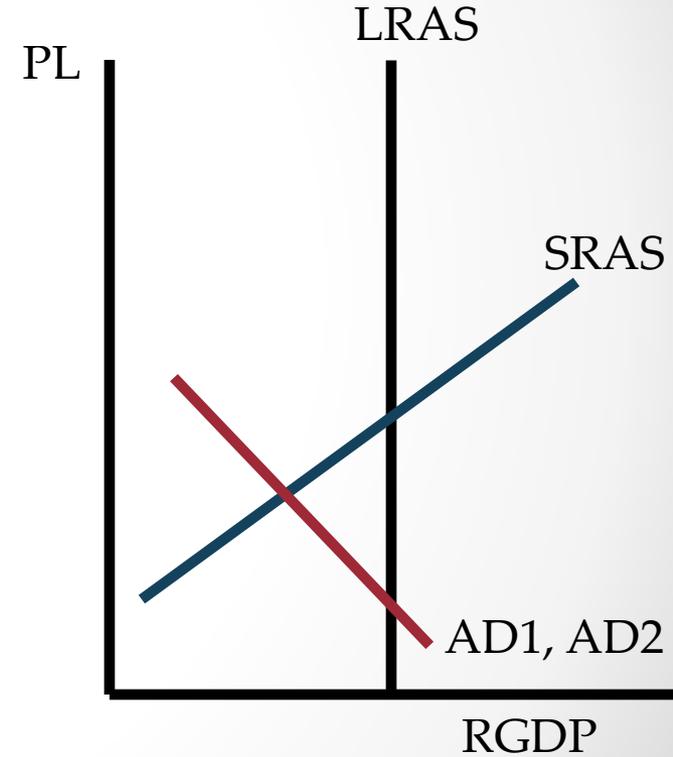
ZERO



PARTIAL



COMPLETE



3 Crowding Out Possibilities

- **ZERO:** the higher interest rates do not change planned investment or consumption (unlikely) so AD1 fully corrects to AD2
- **PARTIAL:** the increase in government spending is larger than the decrease in private investment, but not large enough to fully offset the decrease in Investment so AD1 increases to AD2, then falls to AD3
- **COMPLETE:** the decrease in Investment is equal to or GREATER than the increase caused by the fiscal policy so AD1 does not correct or returns to it's original location
 - **May actually DECREASE!**

Figure 5 The U.S. Government Debt

